

Ag Innovation Guide

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NEW GENERATION COOPERATIVES: A Primer for Missouri Agricultural Producers

This **Ag Innovation Guide** will help you understand the New Generation Cooperative (NGC) organizational form, how an NGC differs from other types of cooperatives, and how producers can benefit from participating in a NGC.

WHAT IS A NEW GENERATION COOPERATIVE?

A NGC is a relatively new type of cooperative used primarily in the value-added processing of agricultural commodities. First used in the upper Midwest in the early 1970s, the NGC organizational form became popular in the early- to mid-1990s for producers interested in collectively adding value to their commodities. The NGC model has since been used for hundreds of new cooperatives across the United States, but has not yet been used extensively in Missouri.

The NGC is not a specific legal structure. Rather, the term "New Generation Cooperative" is used to describe how a firm operates. It primarily describes the relationship between the firm and its members and how the firm is financed. Unlike traditional cooperatives, in which start-up expenses are minimal and growth is financed through members' retained earnings, permanent equity to fund NGC start-up and growth is financed through the sale of delivery rights. These delivery rights represent a member's right to deliver a specific amount of commodities to the cooperative. Members benefit in proportion to their use, and nearly all NGCs are democratically controlled through one member/one vote.

There are five primary characteristics of NGCs:

1) Defined Membership

Frequently, NGCs are referred to as "closed cooperatives." However, "defined" is a more accurate term. The number of members in an NGC depends upon the proposed capacity of the cooperative's operations. One of the key features of the NGC is its ability to control supply or access to the cooperative's operations. In other types of cooperatives, members can enter and exit as they please, and cooperatives operating without marketing contracts with their members have no way to guarantee a specific operating capacity at any one time. By limiting membership

to those members who purchase the right to supply the cooperative, the NGC is able to ensure a steady supply of the agricultural inputs required for running operations at the most efficient level possible. In an NGC, the membership is generally not permanently closed. If the cooperative decides to expand production, for example, it could seek equity from producers outside the initial membership.

2) Delivery Rights: A Right and an Obligation to Deliver

Once members contribute equity toward the NGC, they receive the right, as well as the obligation, to deliver a specific quantity of the commodity each year. This means that if producers have purchased the right to deliver 5,000 bushels of corn each year, they must deliver 5,000 bushels—no more, no less. If they cannot deliver that amount or if the commodity does not meet the quality standards set forth in the marketing agreement (see below), the cooperative may have the right to buy the commodity on the producers' behalf and charge them for the difference in price.

3) Upfront Equity Required From Producers

Adding value to agricultural commodities can be a capital-intensive endeavor. Before lending money to a project, banks and other lending institutions will require producers to raise part of the project cost. Often, this means producers must raise 50 percent or more of the total project cost. If the project is estimated to cost \$1million, for example, producers will need to raise \$500,000 or more. Although it may be possible to find private investors to reach the required equity level, producers are often the sole source of equity.

As a way to tie members' use to the total project equity required, the total amount to be raised is broken into smaller units. These units are tied to the amount of product required to be delivered. A market feasibility study will help determine the most economically efficient size for the processing facility. Once you know the amount of commodities the plant will require each year, you should then determine how to allocate this total amount into shares. For example, if the most efficient size plant requires one million bushels of soybeans a year, you should divide one million into a specific number of shares. To determine the specific number of shares, you should set minimum and maximum amounts of delivery rights to be purchased. To determine this, you need to balance two issues: how many producers do you want involved in the business and what is financially viable for you and other producers to commit.

Example: Assume on the \$1 million project above, producers need to raise \$500,000. If one million bushels a year are required to run the plant at the most efficient level, you could divide the number of bushels into a minimum delivery right purchase of 5,000 bushels and a

maximum of 50,000 bushels. Thus, the cooperative could have as many as 200 members or as few as 20 members.

4) Delivery Rights are Transferable and May Fluctuate in Value

The delivery right is similar to a share of corporate stock because it represents a firm's permanent equity. As with a share of corporate stock, the value of your delivery right will depend on your firm's profitability. If an NGC is successful and provides value for its members, the delivery right may appreciate in value. If the NGC does not provide value to its members, the value of the delivery right may decrease. Unlike stock in a public corporation, however, the delivery right has a very limited resale or trading market. To comply with antitrust, securities, tax and incorporation statutes, NGC bylaws limit transfer to other producers and usually require the board of directors to approve any transfer.

5) Marketing Agreement Entered Into Between Member and Cooperative

Upon purchasing delivery rights, members are required to sign a marketing contract outlining the duties of both the members and the cooperative toward each other with respect to the delivery, quality, and quantity of producers' commodities. These contracts are usually evergreen contracts, meaning they are for specified periods of time (from one to five years). They are renewed automatically unless either party gives notice to the other within a window of time specified in the marketing agreement. The market agreement often specifies the high quality standards required of members' commodities, especially in cooperatives producing consumer-level goods. The marketing agreement outlines the specific quality required to be delivered, how quality will be measured, and the producer's rights and obligations if the quality standard is not met.

As shown in Figure 1, members and their NGC share three primary legal relationships. Members must purchase a share of common stock or other membership interest to enable them to vote in all decisions set forth in the Bylaws. Members also purchase delivery rights, which are both a right and an obligation to deliver. The delivery rights are evidenced by legal documentation and are usually transferable upon approval from the board of directors. Finally, members must sign a marketing agreement when purchasing delivery rights and voting stock. The marketing agreement defines the rights and obligations of both the member and cooperative toward each other with respect to the delivery of commodities from the member to the cooperative.

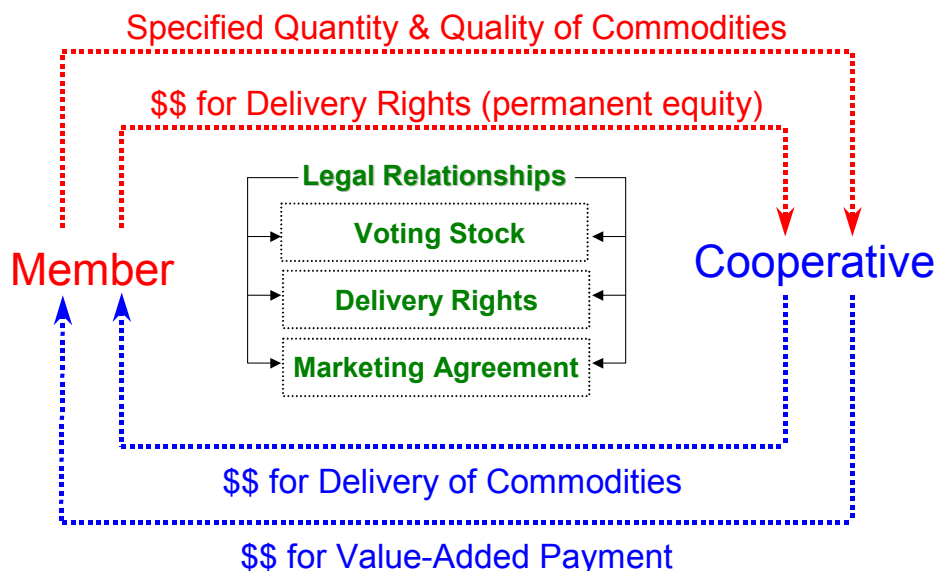
As a result of these three legal relationships, members must pay money to the cooperative for both the voting stock (usually very minimal) and the delivery rights (amount varies on project size, minimum and maximum purchase requirements, and the specific amount of commodity to be delivered by the member). Members also are required to deliver the specified quality and quantity of commodities at pre-specified intervals for the length of the marketing agreement (which is usually, through evergreen contracts, perpetual in nature). The cooperative, in turn, is required to pay members a pre-specified price for the commodities delivered (usually a formula price based on spot market prices at a specified exchange, with additions or subtractions based on quality). The cooperative is also required to return any profits to members on a pre-specified schedule determined by the board of directors. Depending on operating cash requirements, the timeline for returning profits could be immediately. Due to securities law issues, cooperatives are not actively involved in the transfer of delivery rights. The cooperative usually requires approval from the board of directors before any transfer is complete, and sometimes an outside broker handles the actual transfer of delivery rights.

What are the advantages for producer-members of a NGC?

In the NGC, producers benefit in three ways:

- 1) **Price paid for the commodity delivered.** Producers are paid for the commodities delivered to the cooperative. Usually the price is a formula price based on a pre-identified market price and is adjusted up or down based on the quality of the commodities delivered.
- 2) **Value-added payments.** Producers are rewarded for the value added to their commodities through processing or other ways the cooperative adds value to members' commodities. The value-added payment is paid on a patronage basis, meaning that producers' payments are based on the number of delivery rights owned.
- 3) **Potential appreciation of delivery rights.** Because the cooperative membership is limited to producers who have purchased delivery rights and because delivery rights are transferable, the value of the delivery right may appreciate in value. Likewise, the delivery right could fall in value. The potential appreciation aspect distinguishes the NGC from traditional cooperatives.

Figure 1. How a New Generation Cooperative Works



Firms using the NGC model could theoretically be legally organized as a cooperative, limited liability company (LLCs), partnership or corporation. However, most are legally structured as a cooperative. The NGC is more a function of a firm's internal operating documents—its by-laws, operating agreement and other documents—than its legal form. For tax and securities reasons, the cooperative legal structure may be the most appropriate in many cases. However, there are numerous examples across the United States of NGCs formed as LLCs or which use an LLC as an umbrella organization.

The Ag Business Development Staff is here to assist you in starting or expanding your agriculture-based business. Contact us today!



Agriculture Business Development
Missouri Department of Agriculture
P.O. Box 630
Jefferson City, MO 65102
AgInnovationCenter@mail.mda.state.mo.us
Call us toll-free at: 1-866-INOVATE (1-866-466-8283)
<http://www.mda.mo.gov/>

